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No. 80-1918

In the Supreme Court of the United States

October Term, 1980

PENNSYLVANIA GAS AND WATER COMPANY,

Petitioner,

v.

PENNSYLVANIA PUBLIC UTILITY COMMISSION,

Respondent.

[No. 278, January Term, 1978]

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF PENNSYLVANIA

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COUNTER-STATEMENT OF THE QUESTION PRESENTED

Whether the Supreme Court of Pennsylvania, by reviewing the totality of the merits of the Commission's order of August 4, 1976, fully recognized PG&W's constitutional rights on appeal?

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REASON FOR DENYING THE WRIT

No Federal Question Is Presented by PG&W's Petition for a Writ of Certiorari Because the Supreme Court of Pennsylvania Afforded PG&W Comprehensive Review of All Issues Raised on Appeal

Pennsylvania Gas and Water Company's (PG&W) petition for a writ of certiorari is premised entirely on one allegation: that the Pennsylvania Supreme Court, in its decision at 278 January Term 1978, did not review all of the issues raised by PG&W when it initially sought appellate review of a Commission rate decision. That allegation is untrue, and the constitutional arguments presented by PG&W, regardless of their theoretical validity, merit no examination by this Court.

The first step in this controversy was the Commission's own order of August 4, 1976, at Rate Investigation Docket No. 209. By that order, the Commission allowed PG&W $1.3 million of a proposed rate increase of $2.6 million. The Commission, as the forum of original jurisdiction, properly produced an issue-by-issue review of PG&W's case, with reasons cited in support of the Commission's resolution of each issue. Included among those issues were the Commission's findings of PG&W's rate base and rate of return, the two findings challenged by PG&W in its direct appeal of the Commission's order to the Commonwealth Court of Pennsylvania. In particular, the Commission's

order of August 4, 1976, contained five full pages of analysis and discussion of the Commission's rate of return finding (Appendix A).

The Commonwealth Court held that the Commission's finding of PG&W's rate base "was the result of manifest abuse of discretion amounting to an error of law." *Pennsylvania Gas and Water Company v. Pennsylvania Public Utility Commission*, 33 Pa. Commonwealth Ct. 143, 158, 381 A.2d 996, 1004 (1977) (PG&W's Petition for a Writ of Certiorari, Appendix C, p. A38). The Commonwealth Court further found that, regardless of the propriety of the Commission's finding of PG&W's rate of return, PG&W's proper rate base was at least sufficient to support the entire rate increase that had been proposed by PG&W. Because of the latter finding, the Court did not have to address the merits of PG&W's challenge to the Commission's rate of return finding.

The Commission sought and obtained discretionary review of the Commonwealth Court's decision by the Supreme Court of Pennsylvania.[1] The primary focus of the Commission's appeal and of the Supreme Court's decision was the appropriate determination of a public utility's rate base for ratemaking purposes. The Commission insisted and the Supreme Court assured, however, that *both* of PG&W's original

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[1] The Commission's appeal was consolidated for oral argument and decision with another discretionary appeal of a Commonwealth Court decision involving a discrete PG&W rate case. *Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Company*, 19 Pa. Commonwealth Ct. 214, 341 A.2d 239 (1976). The latter appeal, No. 35 May Term 1978, is the subject of PG&W's petition for a writ of certiorari, at No. 80-1917.

challenges to the Commission's order of August 4, 1976, were reviewed comprehensively. The Commission's brief on the merits before the Supreme Court contained six pages (Appendix B) dedicated almost exclusively to the propriety of the rate of return finding in the Commission's order of August 4, 1976. The Commission's decision to address and argue the rate of return issue was prompted by its desire to avoid the very remand to the Commonwealth Court that PG&W apparently seeks through its Petition to this Court. More importantly, the Supreme Court's decision, by its express terms, addressed and resolved the propriety of the Commission's decision on PG&W's *proposed rate increase*, and not merely the Commission's finding of PG&W's rate base.

> ... Based on our analysis of the arguments presented to this Court *on the merits of the rate increase*, we find that the order of the PUC is supported in law and by sufficient facts. Accordingly, we reinstate the order of the PUC entered below.

Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Company, Pa. , , 424 A.2d 1213, 1222 (1980) (PG&W's Petition for a Writ of Certiorari, Appendix A, p. A16) (emphasis added).

Since, as previously noted, the Commission's order of August 4, 1976, fully addressed and resolved PG&W's appropriate rate of return, and despite PG&W's protestations to the contrary, the Supreme Court of Pennsylvania afforded PG&W a complete review of its challenges to the Commission's order.

The syllogism inherent in PG&W's petition for a writ of certiorari fails for want of a valid and essential premise. Ultimately, PG&W's petition is a challenge directed not towards the extent of appellate review provided by the Pennsylvania Supreme Court, but towards the express representation by that Court that comprehensive appellate review was provided. The Commission submits that the highest Court in the Commonwealth of Pennsylvania must be taken at its word.

CONCLUSION

For the foregoing reason, this Honorable Court should deny the petition of the Pennsylvania Gas and Water Company for a writ of certiorari to the Supreme Court of Pennsylvania.

Respectfully submitted,

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APPENDIX A

* * *

FAIR RETURN

Respondent's independent rate of return witness, Joseph F. Brennan, president of a utilities consulting firm, recommends a 9.4 percent rate of return for respondent's water operations. He claims his recommendation is "to be applied to a rate base which reflects at least in part current value of facilities".

The claim is summarized as follows:

TABLE V

Cost of Capital and Fair Rate of Return
(Respondent)

Type of Capital	Capital Ratio	Cost Rate	Composite Cost
	%	%	%
Debt	55.5	7.69	4.26
Preferred Stock	10.6	6.70	0.71
Common Equity	33.9	13.00	4.41
Total	100.0%		9.38%
Cost of Capital and Fair Rate of Return		Use	9.4%

Brennan claims that respondent's proposed water rates will produce less than his recommendation resulting in substandard earnings. In addition, such

earnings, he deems, will not permit respondent's common stock to sell at a market price sufficiently above book value or provide what he believes is adequate interest coverage.

Respondent operates gas and water divisions and finances on a total company basis. Total assets are comprised of approximately 54 percent in gas operations and 46 percent in water operations; however, water operations provide only approximately 25 percent of total revenues. Witness Brennan claims specific segments of capital or costs thereof cannot be identified.

Therefore, he uses total company capital costs with judgment adjustments to reflect risk difference between gas and water operations.

Capital Structure

Respondent's capital structure on a total company basis for various periods and projected by respondent is, as follows:

TABLE V-A

	Test Year End W/O Short Term Debt	Test Year End W/Short Term Debt	Average 1970-74 W/Short Term Debt	Year-End 1975 Estimate (Respondent) W/Short Term Debt	Projected W/Short Term Debt to 1976 (Respondent's Claim)
Debt	57.4%	60.3% (1)	55.1%	57.4% (2)	55.5% (3)
Pfd.	8.0	7.5	8.9	9.7	10.6(4)
Equity	34.6	32.2	36.0	32.9	33.9(5)
Total	100.0%	100.0%	100.0%	100.0%	100.0%

(1) Includes $12,000,000 of short-term debt.

(2) Includes projected $12,000,000 of short term debt.

(3) Estimated $30,000,000 of new bonds to refund maturities and reduce short-term debt.

(4) Includes projected issue of $6,000,000 of preferred stock.

(5) Includes respondent's estimated increase in retained earnings.

PEI's capital structure at December 31, 1974 reflects only minute differences from respondent's year-end 1974 structure ratios. Respondent, stressing the necessity of new financing, claims a capital structure in these proceedings of 55.5 percent debt, 10.6 percent preferred stock, and 33.9 percent common equity.

Respondent, in early 1976, issued $20,000,000 of mortgage bonds and $10,000,000 of preferred stock to refund maturing debt and reduce short-term debt. PEI plans no common stock issues in the near-term future which, respondent claims, is a result of its current depressed market price.

For purpose of rate of return, we find a capital structure for respondent of 56 percent debt, 12 percent preferred stock, and 32 percent common equity.

Debt

Respondent's debt, at the end of the test year, financing both gas and water operations was comprised of $76,600,000 of A-rated first mortgage bonds, $5,925,000 of Small Business Administration Disaster Relief loans, and approximately $25,300,000 of interim and short-term notes payable at a total embedded cost of 6.34 percent. Witness Brennan estimated respondent's embedded cost of debt, including short-term, would be 5.92 percent at year end 1975. This expected decline in embedded cost resulted from the witness' projection of lower interest rates on short and interim-term notes payable.

During the year 1975 no substantial change took place in respondent's total debt, however, average embedded cost did decline because of lower effective

short-term interest rates, to approximate Brennan's 5.92 percent forecast.

Brennan claims respondent will issue $30,000,000 of long-term debt at an estimated cost of 11.0 percent early in 1976 to refund $20,000,000 of maturing debt, reduce short-term debt and meet construction expenditures.

Considering this new debt issue, effective costs of outstanding issues, and discounts on reacquired bonds, Brennan claims, results in an annual cost for respondent's debt of 7.69 percent which is his claim in these proceedings.

We recognize that respondent has long-term debt maturing early in 1976 and its currently high level of short-term debt. Respondent claims that its Articles of Incorporation restrict its short-term debt level to $12,000,000. Respondent, as heretofore stated, has issued out of necessity only $20,000,000 of mortgage bonds at an effective cost rate of approximately 9.6 percent on March 1, 1976. Based on available evidence, we find respondent's cost of debt capital, for purpose of these proceedings, to be 7.17 percent.

Preferred Stock

Respondent had two issues of preferred stock, totalling $13,356,000 outstanding at an annual dividend requirement of 4.53 percent at the end of the test year. Witness Brennan claimed an additional issuance of $6,000,000 of preferred stock in late 1975 or early 1976, at an estimated cost of 11.5 percent which would increase respondent's annual cost of preferred stock to 6.70 percent which is his claim in these pro-

ceedings. Respondent, in its brief, claimed it was attempting, at that time, to sell $6,000,000 to $10,000,000 of preferred stock and estimated the cost to be 12.0 percent.

Preferred stock issuance in lieu of additional debt, respondent claims, is to maintain a capital structure balance and preserve the Company's A bond-rating. In addition, respondent claims its capability of meeting the dividend coverage requirements for preferred issuance affords greater latitude than meeting debt interest requirements under its Note Agreement for additional debt issuance.

Recognition of the need for respondent's additional financing is necessary. A review of respondent's construction program and matching financing does not demonstrate that additional capital requirements are significantly disproportionate between respondent's gas and water operations. We recognize that the increasing level of respondent's short-term debt and ceiling restrictions thereon will require a balancing of capital segments including preferred stock. Respondent, as previously stated, issued $10,000,000 of preferred stock in early 1976 at an effective cost rate of 10.2 percent. For purpose of these proceedings, we find 6.95 percent as respondent's cost of preferred stock.

Common Equity

Witness Brennan, through a market related approach and judgment, claims 13 percent as respondent's cost of common equity capital financing its water operations. He claims this cost rate is applicable when applied to a rate base reflecting current values and financed by 33 percent common equity.

The development of his 13 percent cost rate of common equity was based primarily on data of the seven largest water companies of a group of fourteen which he claims are the only publicly owned water companies having stock actively traded. He selected the seven largest water companies on the basis of size similar to respondent's water operations. In addition to the water company data, he also observed recent five-year trends and latest available market data for Moody's 24 Electrics and Moody's 10 Gas Distribution Companies. He claims investors view PG&W primarily as a gas company.

Brennan relied extensively on adjusted earnings-price ratios of respondent and his group of the seven largest water utilities for determining a cost of respondent's common equity capital applicable to water operations. An upward adjustment factor of 13 percent was made by Brennan to earnings-price ratios of water utilities to offset the effects of issuance expense and market pressure which are associated with new issues of water utility common stocks. He adjusted non-water utility earnings-price ratios by 10 percent. Supplementing his adjusted earnings-price ratio data, the witness observed trends of net-proceeds ratios, market price-book value ratios, and the results of his bare rent plus inflation allowance and risk method.

Brennan claims no weight was given to earnings-book ratios on the basis that such ratios, if adequate, would have permitted PEI's common stock to maintain a market price of 125 to 150 percent of book value which ratio area he claims is necessary to maintain capital integrity. Also rejected by the witness was the Discounted Cash Flow Method (DCF) for determining

a cost of common equity. He stresses irregularity of past market performance does not support the validity of this method. Interest coverage, Brennan claims, is a testing tool of adequacy of return and not a method he employed in determining his common equity cost rate. A tabulation of witness Brennan's primary market data with available updatings is as follows:

TABLE VI

Adjusted Earnings-Price Ratios*

	1970-1974	1972-1974	1974	Apr. 1975	(late) 1975
	%	%	%	%	%
PG&W (PEI)	13.9	15.5	20.4	22.0	20.3
7 Water Co.	12.7	13.2	14.1	14.0	14.2
14 Water Co.	13.2	13.9	14.7	15.1	**14.5
Moody's 10 Gas	11.4 (1969-1973)	12.0 (1971-1973)	14.0 (1973)	13.4	16.3
Moody's 24	9.9	10.6	11.8	17.9	14.7

*E/p ratios adjusted by 10% to reflect flotation costs: water utility data adjusted by 13%.

**Data available for 9 of the 14 companies only.

TABLE VI(A)

Market Price-Book Value Ratios
Earnings-Book Value Ratios

	1970-1974 MP/BV-E/BV		1970 MP/BV-E/BV		1974 MP/BV-E/BV		(late) 1975 MP/BV-E/BV	
	%	%	%	%	%	%	%	%
PG&W (PEI)	89 -	10.9	108 -	11.2	56 -	10.6	60 -	11.0
7 Water Co.	96 -	10.5	98 -	10.6	81 -	10.3	76 -	9.4
14 Water Co.	89 -	10.0	94 -	10.2	75 -	9.6	*74 -	9.3
Moody's 10 Gas	120 - (1969-1973)	12.0	129 -	12.5	82 - (1973)	11.1	91 -	12.6
Moody's 24	127 -	12.1	127 -	12.0	100 -	11.5	84 -	10.8

*Data available for 9 of the 14 companies only.

Witness Brennan's market data indicates generally an upward trend of his common equity cost indicators. However, spot costs, as shown by the 1975 data, can be given only minor consideration in view of recent past economic conditions. Meaningful data for determining an applicable common equity cost rate allowance must span a period representative of financial performance and market conditions which are likely to occur when any proposed rates are in effect.

The witness stresses that only increased earnings can produce a market price sufficiently above book value for PEI's common stock. However, evidence he presented does not show any of his reference groups having recently experienced the level of market price to book value he claims necessary for respondent's stock. He claims a water utility stock should sell at 40 to 50 percent in excess of book value. We recognize that generally financial well being is indicated when common stock sells in excess of book value; however, sufficient evidence was not presented to support the supposition that earnings alone, within bounds of reasonableness, can achieve this goal under conditions of our present economy.

Brennan claims that respondent's diversification into non-utility endeavors would, over the long-term, enhance the value of respondent's common stock. To date, no measurable effect of the formation of PEI can be detected in its stock price which assumedly reflects the effects of utility operations alone.

Brennan's use of common equity cost indicators are those generally accepted in the money markets. We agree that earnings-price ratios and the myriad of measurements and data presented by the witness and supplemented by judgment constitute a logical basis for determining a cost of common equity capital for respondent. However, consideration must be given to respondent's gas operations and its supply problems and their effect on respondent's overall cost of common equity capital. Brennan claims that were he to give a common equity cost recommendation relative to gas operations alone it would be higher. Respondent's water operations comprising approximately 25 percent of total utility revenues as heretofore stated, offer an element of stability to overall utility financial performance. Generally, water utility common stock has historically sold at lower market to book multiples and have achieved on average lower returns than either gas or electric utilities.

PEI, though with higher common equity book return ratios than comparison water groups, remains in the bottom of the market price-book value ratio range. However, recent data shows that water common stocks have indicated an improvement in cost areas over gas common stocks. Based on available evidence, we find respondent's cost of equity capital applicable to its water operations in these proceedings to be in the range of 11.50 to 12.00 percent.

Conclusion

Based on available cost of capital evidence, we find 8.53 percent to be respondent's proper rate of return. Applying the 8.53 percent to our fair value of $87,700,000 results in an allowable return of $7,482,668.

The staff's recommendation would provide a 20.05 percent return on respondent's original cost common equity invested solely in water operations (excluding acquisition adjustment of $14,600,000), which would be excessive. Our finding of allowable revenues results in a 17.28 percent return on original cost common equity invested solely in water operations (excluding acquisition adjustment of $14,600,000), which we consider to be reasonable.

APPENDIX B

* * *

B. FAIR VALUE RATE BASE NO LONGER SERVES THE PURPOSE FOR WHICH IT WAS CREATED

Public utility rate regulation is a balancing process in which the right of the utility's investors to a return on their investments is weighed against the right of the utility's ratepayers to be exempt from unreasonable exactions. *Smyth v. Ames.* It follows, therefor, that any ratemaking device, whether flexible or rigid, must promote this balancing of rights in order to justify both its development *and* its continued vitality. When a formerly acceptable ratemaking device serves the opposite purpose, that is, when it promotes an imbalance in the ratemaking process, it must be abandoned in favor of devices that serve the desired purpose.

The "fair value" rate base was created to correct an existing imbalance in the ratemaking process. Contrary to what our modern analysis of "fair value" would reveal, that existing imbalance was not one that favored the interests of the utilities' ratepayers:

> But *the rights of the public would be ignored* if rates for the transportation of persons or property on a railroad are exacted without reference to the fair value of the property used for the public....

Smyth v. Ames at 544. (emphasis added).

Obviously, the United States Supreme Court perceived "fair value" as a device which would correct an imbalance that had existed in favor of the rights of the utilities' investors. Whether the United States Supreme Court of 1898 anticipated the continued vitality of "fair value" into the 1970's is not important. The only important observation is that "fair value" was created in response to a specific problem or imbalance. The questions that this modern Court must resolve are whether the abolition of "fair value" will promote an imbalance in favor of the utilities' investors or whether, as the Commission here advocates, the continued vitality of "fair value" already has promoted such an imbalance? The answers to both questions are provided by the case now before this Court.

To prove its entitlement to a specific fair return on its rate base and its entitlement to a specific, reasonable profit, PG&W produced evidence of its investor-supplied funds and the returns on investment that its investors reasonably could have anticipated. At the end of PG&W's test year, or on September 30, 1974, the funds actually supplied to PG&W by investors were carried on PG&W's balance sheet at a value of $76,748,412[5], computed as follows:

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[5] This, of course, represents only those funds invested in PG&W—*Water Division*, Respondent herein. For ratemaking purposes, PG&W's Water Division has been and is analyzed separately from and independently of PG&W's Gas Division.

TABLE II

A)	Capital Stock (common & preferred):	$ 44,425,591*
	Long-term debt:	95,828,572*
	Retained earnings:	26,590,211*
	Total (Water and Gas Divisions):	$166,844,374
B)	$166,844,374 x 46%** (attributable to water operations) = $76,748,412 (invested in water operations)	

* PG&W Ex. No. 1A, p. 41, (R. 103a)
** PG&W Ex. No. 1A, p. 40, (R. 102a)

Of the total of $76,748,412, the Commission found that PG&W's capital structure, or percentage of investment by kind, was 56% debt, 12% preferred stock, and 32% common equity. (Commission order of July 7, 1976, p. 19, R. 309a). When applied to the total amount invested, these percentages produce the following results:

TABLE III

	Capital Structure		Total Investment		Investment By Kind
Debt	56%	x	76,748,412	=	42,979,111
Preferred Stock	12%	x	76,748,412	=	9,209,809
Common Stock	32%	x	76,748,412	=	24,559,492

The Commission found that $42,979,111 had been invested in PG&W by holders of debt, $9,209,809 by holders of preferred stock, and $24,559,492 by holders of common stock. The Commission also found that PG&W's allowable profit was $7,482,668, a figure derived from the application of the Commission's rate of return finding of 8.53% to the Commission's *fair value* rate base finding of $87,700,000. Taking the

total profit of $7,482,668 and breaking it down by kind of investment, the Commission's order of July 7, 1976 allowed PG&W's common equity holders the opportunity to earn $3,760,984, computed as follows:

TABLE IV

A)	Amount Invested	Cost Rate[6]		Cost of Investment
Debt	$42,979,111 x	7.17%	=	$3,081,602
Preferred Stock	9,209,809 x	6.95%	=	640,082
Total (Debt and Preferred)			=	$3,721,684

B)		
	$7,482,668	(total allowable profit)
	− 3,721,684	(costs of debt and preferred stock)
	$3,760,984	(profit allowable for return on common stock)

When the $3,760,984 allowable profit is applied to the common stock investment of $24,559,492, the Commission's order of July 7, 1976 allowed PG&W's common stockholders the opportunity to earn a *15.3%* return on their investments.[7]

Turning again to PG&W's evidentiary presentation, PG&W's rate of return witness relied, in part, on comparison to "Moody's 24 Public Utilities" (a national "barometer" group) when he formed his judgment of a reasonable return to PG&W's common stockholders.

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[6] The costs of debt and preferred stock generally are non-controversial issues in utility rate cases, since both costs are fixed, contractual obligations.

[7] This computation actually is conservative because, for this purpose, we have assumed that *all* of the funds invested in PG&W were "used and useful in the public service."

(PG&W Statement No. 3, p. 51-55, R. 73a-77a). The relevant, comparable data were presented as follows:

TABLE V*

Year	Ratio of Avg. Market Value of Common Stock to Avg. Book Value of Common Stock	Earnings per Avg. Book Value of Common Stock
1970	126.9 %	12.0 %
1971	129.0 %	12.1 %
1972	117.3 %	12.5 %
1973	100.2 %	11.5 %
4 Year Average	118.35%	12.04%

* PG&W Ex. No. 3A, Schedule 3, (R.127a)

During the four years from 1970 through 1973, these "barometer" utilities earned an average return on common equity that was more that 3% *lower* than the return allowed PG&W by the Commission's order of July 7, 1978. And, during the same period, the common stocks of these same "barometer" utilities maintained a more than respectable average market value/book value ratio of 118.35%. By any national standard, the Commission's order of July 7, 1978 was generous, if not magnanimous. Yet, the Commonwealth Court found that the Commission's order promoted an imbalance in favor of the rights of the PG&W's ratepayers and to the detriment of PG&W's investors.

While the Commonwealth Court properly identified the existence of an imbalance, it improperly identified the beneficiaries of the imbalance. Because of this confusion, the steps that the Court followed in

order to restore balance actually aggravated the existing imbalance.[8] The source of the Commission's reluctant promotion of an imbalance in the ratemaking process, and the source of the Commonwealth Court's inadvertant aggravation of the imbalance were the same, the "fair value" rate base. Despite the Commission's own best and reasoned judgment, the Commission was coerced into allowing PG&W the opportunity to earn: 1) excessive revenues; 2) revenues that favored the rights of PG&W's investors, to the detriment of PG&W's ratepayers; and 3) revenues that few, if any other states would have allowed PG&W.

The Commission submits that "fair value" has strayed far from the course set for it by its creators, the United States Supreme Court of 1898. The Commission submits that "fair value" has not served, does not serve, and will not serve the purpose for which it was created. The Commission submits that "fair value" acts at cross-purposes with its creators' goals, and both promotes and aggravates an imbalance between the rights of utility ratepayers and investors. Finally, the Commission submits that nothing less than the abolition of "fair value" will permit the restoration of balance to the ratemaking process.

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[8] The Commonwealth Court's decision allowed PG&W's common stockholders the opportunity to earn about a 17.8% return on the book value of their stock, a return that is almost 6% greater than that earned by stockholders of comparable utilities nationwide. (Table V, *supra*).